

In the United States
Circuit Court of Appeals
For the Ninth Circuit

C. A. VAN DUSEN, PETITIONER

vs.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

On petition for review of the decision of the Tax
Court of the United States

Brief for the Petitioner

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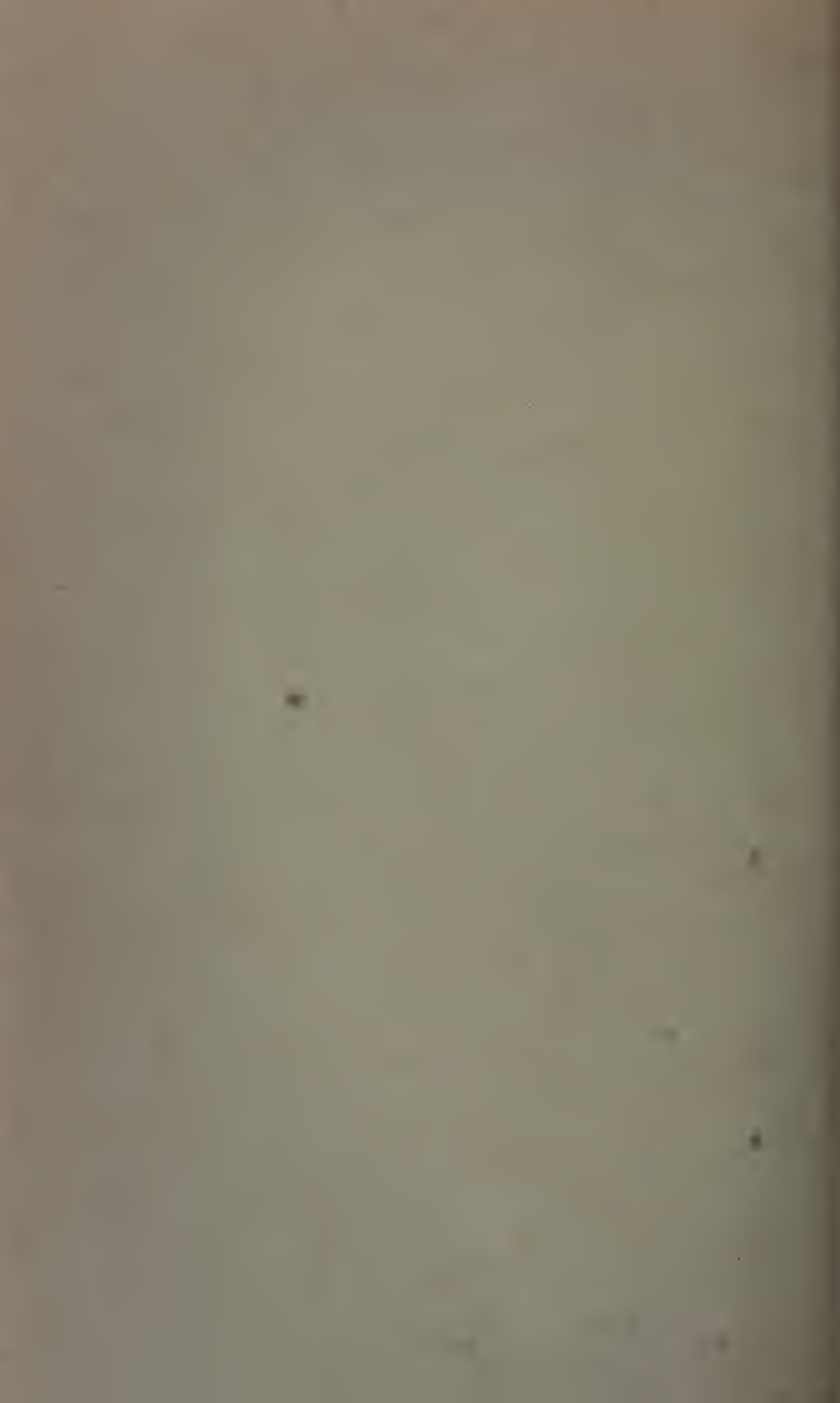
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FOR THE NINTH CIRCUIT

No. 11,699

C. A. VAN DUSEN, PETITIONER

v's.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

**On petition for review of the decision of the Tax
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Brief for the Petitioner

OPINION BELOW

The opinion of the Tax Court of the United States (R. 95-106.) may be found in 8 T. C. 388.

JURISDICTION

The petition for review involves deficiencies in income taxes as follows:

Year	Deficiency
1938	\$ 310.66
1939	528.22
1940	1,251.02
1941	4,863.30

Said deficiencies are set forth in the decision of the Tax Court entered May 1, 1947. (R. 107.) The taxpayer filed his income tax returns for the years in question with the Collector of Internal Revenue for the Sixth Collection District of California. (R. 30-92.) On March 10, 1944, the Commissioner mailed a statutory notice of deficiency to the taxpayer. (R. 9-18.) On June 5, 1944, the taxpayer filed a petition with the Tax Court for redetermination of his income tax liability pursuant to Section 272(a)(1) of the Internal Revenue Code. (R. 2-18.) The final order and decision of the Tax Court deciding that there were deficiencies in income tax was entered on May 1, 1947. (R. 107.) The petition for review of the Tax Court decision by the Circuit Court of Appeals for the Ninth Circuit was filed June 20, 1947 (R. 108-110.), pursuant to the provisions of Sections 1141 and 1142 of the Internal Revenue Code.

QUESTION PRESENTED

Whether petitioner realized taxable income in 1938, 1939, 1940 and 1941 at the times of exercise of a continuing option to purchase stock of a corporation, of which corporation petitioner was an employee, when the option was not given by and the purchases were not made from the employer corporation but by and from the corporation's president personally, and when the option had value at the time it was given to petitioner on December 7, 1934.

STATUTE AND REGULATIONS INVOLVED

Revenue Act of 1934, C 277, 48 Stat. 680:

"Section 22. Gross Income.

"(a) General Definition.—'Gross income' includes gains, profits, and income derived from salaries, wages, or compensation for personal service, of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. In the case of Presidents of the United States and judges of courts of the United States taking office after June 6, 1932, the compensation received as such shall be included in gross income; and all Acts fixing the compensation of such Presidents and judges are hereby amended accordingly."

Article 22, Regulations 86:

"(a)-1. What included in gross income.—Gross income includes in general compensation for personal and professional services, business income, profits from sales of and dealings in property, interest, rent, dividends, and gains, profits, and income derived from any source whatever, unless exempt from tax by law. * * * In general, income is the gain derived from capital, from labor, or from both combined, provided it be understood to include profit gained through a sale or conversion of capital assets. Profits of citizens, residents, or domestic corporations derived from sales in foreign commerce must be included in their gross income; but special provisions are made for nonresident aliens by sections 211-214 and, in certain cases, by section 251, for citizens and domestic corporations

deriving income from sources within possessions of the United States. Income may be in the form of cash or of property. As to dividends, whether in cash or in property, see section 115.

"If property is transferred by a corporation to a shareholder, or by an employer to an employee, for an amount substantially less than its fair market value, such shareholder of the corporation or such employee shall include in gross income the difference between the amount paid for the property and the amount of its fair market value. In computing the gain or loss from the subsequent sale of such property its cost shall be deemed to be its fair market value at the date of acquisition by the shareholder or the employee. This paragraph does not apply, however, to the issuance by a corporation to its shareholders of the right to subscribe to its stock, as to which see article 22(a)-8."

* * *

"(a)-2. Compensation for personal services.— Commissions paid salesmen, compensation for services on the basis of a percentage of profits, commissions on insurance premiums, tips, pay of persons in the military or naval forces of the United States, retired pay of Federal and other officers, and pensions or retiring allowances paid by private persons or by the United States are income to the recipients; as are also marriage fees, baptismal offerings, sums paid for saying masses for the dead, and other contributions received by a clergyman, evangelist, or religious worker for services rendered. However, so-called pensions awarded by one to whom no services have been rendered are mere gifts or gratuities and are not taxable. The salaries of Federal officers and employees are subject to tax. See article 116-2 as to compensation of State officers and employees."

"(a)-3. Compensation paid other than in cash.— If services are paid for with something other than money, the fair market value of the thing taken in

payment is the amount to be included as income. If the services were rendered at a stipulated price, in the absence of evidence to the contrary such price will be presumed to be the fair value of the compensation received. If a corporation transfers to its employees its own stock as compensation for services rendered by the employee, the amount of such compensation to be included in the gross income of the employee is the fair market value of the stock at the time of the transfer. If living quarters such as camps are furnished to employees for the convenience of the employer, the ratable value need not be added to the cash compensation of the employees, but if a person receives as compensation for services rendered a salary and in addition thereto living quarters, the value to such person of the quarters furnished constitutes income subject to tax."

STATEMENT

The relevant facts as stipulated (R. 23-29.) and as found by the Tax Court are as follows: On December 10, 1934, C. A. Van Dusen, petitioner herein, entered the employ of Consolidated Aircraft Corporation as factory manager at a salary of \$9,000 per annum. (R. 96.) At all times from December 7, 1934, to December 31, 1934, petitioner was the employee of Consolidated Aircraft Corporation. (R. 100.) On December 7, 1934, R. H. Fleet was president of Consolidated Aircraft Corporation. (R. 97.) On December 7, 1934, R. H. Fleet gave to petitioner an oral option to purchase stock of Consolidated Aircraft Corporation from Fleet (R. 97.), and on December 10, 1934, said option was reduced to writing. (R. 97.) Said written option was as follows:

"Consolidated Aircraft Corporation
Buffalo, New York

R. H. Fleet,
President.

December 10, 1934.

Mr. Charles A. Van Dusen, (Confidential)

Dear Van:

In connection with your employment this day by our company, it gives me much pleasure to confirm my offer to sell you fifty (50) shares of my personal common stock in this corporation at the price of \$5 net per share each and every month for the next ten years (unless I die or cease to be an employee of Consolidated, in which event this is modified against me or my estate to five years from this date), this right to hold, however, only so long as you are retained in the company's employ.

You are under no obligation to purchase or to hold after purchase, any such stock under this offer; failing to purchase any month you forfeit nothing but the right to buy that month's quota of 50 shares.

So that you may get prompt delivery of any shares you purchase hereunder, I will leave sufficient of my shares, in street names, properly endorsed, with the Treasurer of the company to fulfill this agreement.

Until I further advise, would prefer that if you sell you do so only to or thru our brokers, Hammons & Company, 120 Broadway, New York City, (phone Rector 2-4400).

Cordially,
/s/ R. H. FLEET"

On December 15, 1941 it was mutually agreed between Fleet and petitioner that the option agreement would terminate on December 31, 1941. (R. 98.)

The common stock of Consolidated Aircraft Corporation had a par value of \$1 per share and a book value of \$3.55 per share at December 7, 1934. (R. 99.) On Decem-

ber 7, 1934 the common stock of Consolidated Aircraft Corporation sold on the New York Curb Exchange for a high of $9\frac{1}{2}$ and a low of $8\frac{7}{8}$. (R. 99.) The option price was \$5 per share. (R. 98.) There were 574,400 shares of the common stock of Consolidated outstanding on December 7, 1934 and R. H. Fleet owned 261,481 shares of the common stock on that date. (R. 99.) Petitioner purchased common stock of Consolidated from R. H. Fleet under the terms of the agreement set forth above as follows (R. 100.):

Year	Shares	Market value when purchased.	Cost
1938	600	\$10,653.75	\$3,000.00
1939	750	14,484.38	3,750.00
1940	400	9,875.00	2,000.00
1941	600	18,000.00	3,000.00

R. H. Fleet claimed no deductions from gross income in his returns for the calendar years 1938, 1939, 1940, 1941 for the difference between the fair market value of the common stock of Consolidated and the sale price of the common stock to petitioner, but reported as income in his returns for said years the difference between the basis of the stock to him and the sum of \$5 per share received on the sales to petitioner. (R. 100-101.)

Consolidated Aircraft Corporation claimed on its returns as deductions from gross income for the years 1938, 1939, 1940 and 1941 only the salary paid by it to the petitioner for those years and did not claim any deduction on account of the sales of its stock by R. H. Fleet to the petitioner during those years. (R. 101.)

The Tax Court has found that the option was given to petitioner by Fleet as an inducement to secure his services for Consolidated. (R. 100.) Furthermore, the Tax Court has purported to find that the difference between the amount paid for the stock and its fair market value at the several dates of purchase was in the nature of compensation for services rendered or to be rendered by petitioner. (R. 101.) The Tax Court has held that petitioner realized taxable income at the times of purchase of the stock pursuant to the option in an amount equal to the difference between the price paid by petitioner and the market value of the stock at the dates of purchase.

STATEMENT OF POINTS TO BE URGED

The petitioner's assignments of error, all of which are here relied upon, appear in the Record at pages 114-115. They may be summarized by the simple statement that the Tax Court erred in holding that petitioner realized taxable income at the time of purchasing the stock pursuant to the terms of the option.

SUMMARY OF ARGUMENT

The purported finding of the Tax Court that the difference between the amount paid for the stock and its fair market value at the several dates of purchase was in the nature of compensation for services rendered or to be rendered by the petitioner is in reality a conclusion of law which is subject to judicial review, and is a conclusion which is not supported by law or fact.

Assuming *arguendo* that the option was compensation

to petitioner, since the option had value at the date it was given, petitioner realized income upon receipt of the option and not at the dates of purchase of the stock as held by the Tax Court.

ARGUMENT

The purported finding of the Tax Court that the difference between the amount paid for the stock and its fair market value at the several dates of purchase was in the nature of compensation to petitioner is a conclusion of law not supported by law or fact.

The Tax Court has based its decision upon the expansive scope of Section 22(a) and the decision of the Supreme Court in *Commissioner v. Smith*, 324 U. S. 177. However, it should be noted that the Tax Court has not found that petitioner was the employee of Fleet from whom the Consolidated stock was purchased, nor has the Tax Court found that Fleet was acting for and on behalf of Consolidated in granting the option. On the contrary, the Tax Court has found that petitioner was the employee of Consolidated (R. 100.), and that petitioner purchased the stock from Fleet (R. 100.). *Commissioner v. Smith, supra*, is distinguishable on its facts from the instant case in that the option in the *Smith* case was granted by an employer to an employee, while in the instant case the Tax Court has not found that an employer-employee relationship existed between Fleet, the grantor of the option, and petitioner, and in fact such relationship did not exist.

The Tax Court has purported to find that the option was in the nature of compensation for services rendered or to be rendered by petitioner. This purported finding of the Tax Court is actually a conclusion of law to be distinguished from true findings of primary evidentiary or circumstantial facts. It is subject to review and on such review the Court may substitute its judgment for that of the Tax Court. (*Bogardus v. Commissioner*, 302 U. S. 34, 38, 39.) There is no basis in law or in fact for the holding of the Tax Court that petitioner acquired the stock as compensation for services. The only services petitioner rendered were to his employer, Consolidated, for which he was fully compensated by salary. (R. 96-97.) Petitioner was not the employee of Fleet, the seller of the stock, nor did petitioner render services to Fleet. Petitioner acquired the Consolidated stock from Fleet by purchase pursuant to an option, and realized no income at the time of such purchase.¹ Since petitioner was not the employee of Fleet, *Commissioner v. Smith, supra*, upon which the Tax Court mainly based its opinion is clearly distinguishable.

The decisive factor which determines the question of whether petitioner realized taxable income out of the receipt of the option or the purchase of stock is the intention of the grantor. (*Bogardus v. Commissioner, supra*; *Palmer v. Commissioner*, 302 U. S. 63.) If Fleet intended to compensate petitioner, petitioner realized taxable income. However, if Fleet did not intend to compensate no taxable in-

¹*Bothwell v. Commissioner*, 10 Cir., 77 F. 2d 35; *Rossheim v. Commissioner*, 3 Cir., 92 F. 2d 247; *Hawke v. Commissioner*, 9 Cir., 109 F. 2d 946. See, also, *Gardner-Denver Co. v. Commissioner*, 7 Cir., 75 F. 2d 38; *Omaha Nat. Bank v. Commissioner*, 8 Cir., 75 F. 2d 434.

come was realized.¹ In *Palmer v. Commissioner, supra*, a corporation gave its stockholders the right to purchase stock which it owned in another corporation. The stockholder was held to have realized no income, either upon the receipt of the right or upon the exercise, even though the right had value at both times. The court emphasized the absence of an intention to distribute anything of value. The court held that since the directors did not intend to distribute anything at the time the corporation adopted the plan, it was immaterial that the right had value at the time of distribution and exercise of the rights. Moreover, the Commissioner in his brief before the Supreme Court in *Commissioner v. Smith, supra*, has recognized that the intention of the grantor of an option or the vendor in a bargain purchase is determinative of whether income is realized by the purchaser.²

The decisive question is did Fleet, the grantor of the option, intend to compensate petitioner. While Fleet, the grantor of the option, may have intended to benefit petitioner and Consolidated, it does not follow that he intended to compensate petitioner. The intention of the grantor to induce action in the grantee by conferring a benefit does not make the benefit taxable income to the grantee. (*Ed-*

¹Cf. Article 22(a)-2 Regulations 86, *supra*: * * * "However, so-called pensions awarded by one to whom no services have been rendered are mere gifts or gratuities and are not taxable." * * *

²The Commissioner said in his *Smith* case brief: "While the Regulations contain no further definition of compensation, there is a strong presumption that all gains flowing from the employer-employee relationship are in the nature of compensation. This may not always be true so far as bargain purchases are concerned. Conceivably such a bargain may occur where an employer can find no other buyer in a stagnant market, or even where the sole purpose is to ensure the employee's unflagging loyalty by giving him a stake in the employer's business."

wards v. Cuba Railroad, 268 U. S. 628; *Bogardus v. Commissioner*, *supra*; *Helvering v. American Dental Co.*, 318 U. S. 322, 331; *McDermott v. Commissioner*, CCA, D. C., 150F(2) 585; *Pauline C. Washburn*, 5 T. C. 1333.) Since petitioner was not the employee of Fleet, and since petitioner rendered no services to Fleet, there is no basis in law or in fact for the Tax Court's conclusion that the option was in the nature of compensation for services rendered by petitioner.¹

Assuming *Arguendo* that petitioner received the option as compensation for services rendered or to be rendered, petitioner realized income in the year in which the option was granted and not in the year of purchase of the stock.

Petitioner's option to purchase Consolidated stock provided that he might purchase from Fleet 50 shares of Fleet's stock per month for a period of ten years at a price of \$5 per share. (R. 97-98.)² On the day the option was given to petitioner the common stock of Consolidated Aircraft sold on the New York Curb Exchange for a high of 9½ and a low of 8⅞. (R. 99.) It is clear that at the time the option was granted it had value. The Supreme Court in *Commissioner v. Smith*, *supra*, based its decision upon the

¹Fleet took no deduction for compensation paid in his income tax returns on account of the option or sale. (R. 100-101.) If he had intended to compensate petitioner such deduction would have been claimed. Since no deduction was claimed, and since such deduction would have resulted in a substantial tax saving to Fleet this is a strong indication that Fleet did not intend to compensate petitioner.

²The option was noncumulative and terminated if petitioner left the employ of Consolidated; furthermore, the option extended for five years only if Fleet died or left the employ of Consolidated.

fact that in that case the option had no value at the time it was granted. The court expressly pointed out at page 181 of its decision: "When the option price is less than the market price of the property for the purchase of which the option is given, it may have present value and may be found to be itself compensation for services rendered." And again at page 182 the Supreme Court states: "It of course does not follow that in other circumstances not here present the option itself, rather than the proceeds of its exercise, could not be found to be the only intended compensation."

The Tax Court has completely ignored the basis of the Supreme Court's decision in the *Smith* case. In the instant case the Tax Court has found facts which clearly establish that the option had value at the time it was granted. Assuming *arguendo* the validity of the Tax Court's purported finding that the option was intended to be compensation to petitioner, since the option had value at the time it was granted the only taxable income realized by petitioner was the value of the option when received by petitioner. The Tax Court has erred in holding that petitioner received income at the times that purchases were made pursuant to the option. We submit that there is no reasonable basis for wholly disregarding the finding of fact that the market price exceeded the option price by a substantial amount at the time the option was granted. Since the market price of the stock exceeded the option price at the time the option was granted, if compensation was intended as purportedly found by the Tax Court, petitioner realized income in the year the option was granted and not in the years the option was exercised as determined by the Tax Court. The con-

clusion of the Tax Court ignores its own finding of fact and is directly contrary to the Supreme Court's decision in *Commissioner v. Smith, supra*.

CONCLUSION

The Tax Court erred in holding that there are deficiencies in petitioner's income taxes for the years 1938, 1939, 1940 and 1941. Its decision should be reversed.

Respectfully submitted,

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